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C O N F I D E N T I A L SECTION 01 OF 03 LIMA 001714

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E.O. 12958: DECL: 10/27/2018
TAGS: ECON EFIN ETRD EINV ECIN PGOV PREL PE
SUBJECT: PERU'S ECONOMY: MORE PROTECTED THAN MOST FROM THE
GLOBAL FINANCIAL CRISIS

Classified By: Ambassador P. Michael McKinley, reasons 1.4 a & d

SUMMARY

¶1. (C) Peru's economy will slow as a result of the global financial crisis, but its relatively low exposure to risky external debt and high liquidity should soften the potential blow. Like its counterparts around the world, the Lima Stock Exchange has dropped significantly, sharply reducing the value of individual holdings in the national pension system (AFP) and the paper value of companies listed on its exchange. Falling commodity prices will lower the value of Peru's principal export earners (minerals represent 63%), but this could be mitigated, over the longer term, by the diversification of its export base (agricultural goods, oil and gas) and external markets (Asia, Europe, and Latin America as well as the U.S.). These however, are also likely to be affected by the downturn. Key investment projects worth potentially billions are also likely to be postponed. As it seeks to protect past gains amid wider questioning of the "liberal" economic model, the GOP will need to decide whether belt-tightening or increased spending is the best way to navigate the global financial crisis. End Summary.

PERU'S ECONOMY REMAINS SOLID -- FOR NOW

¶2. (SBU) Like other countries around the world, in Peru the financial crisis was thought initially to be a U.S. problem. That perception has changed as the blast from the initial financial detonation in the U.S. has expanded outward to other countries and continents, including in Latin America. While few know precisely what consequences will come, and initial optimism about Peru's ability to weather the storm has cooled somewhat with successive waves of troubling news, Peru's economic foundations up to now have been solid. The Ministry of Economy and Finance projects that Peru will grow 9% this year -- the fastest in all of Latin America -- and up to 7% in 2009. According to the International Monetary Fund's (IMF) World Economic Outlook published in October 2008, Peru is estimated to have the 9th highest GDP growth (9.2%) in the world (181 countries) in 2008 and the 22nd highest (7.0%) in 009. Peru's trade balance is expected to have another surplus in 2009, bolstered by increasing and diverse investment and foreign markets, including regional neighbors, the U.S., Europe and Asia. Inflation, at 6.2% in September, remains the lowest in the region. IMF estimates that Peru will have the 2nd lowest inflation in Latin America in 2008 (5.8%) and 2009 (3.5%). The GOP has relatively low

debt burdens, having reduced both its absolute foreign debt level and its debt as a percentage share of GDP. In that sense, the Peruvian financial system has relatively low exposure to the underlying causes of the global crisis and is as well positioned as any to avoid the brunt of the difficulties. Peruvian Minister of Economy and Finance Luis Valdivieso recently told US Treasury Secretary Paulson that Peru has ample liquidity to face the global crisis.

LIMA STOCK EXCHANGE -- ROLLER COASTER

¶3. (SBU) However strong its fundamentals, Peru's economy has not and will not escape unscathed from the crisis. One immediate impact has been on Peru's stock market, which has gyrated wildly and dropped significantly since early October. On October 10, local papers reported an historic decline of the Lima Stock Exchange (Bolsa de Valores de Lima -- BVL), the General Index fell approximately 11.24%. Mining companies saw the heaviest losses due to the decline in prices for copper and zinc. On October 13, the BVL rebounded with its greatest jump in 18 years, with a 13.67% increase. The Peruvian stock exchange appears to be following the same pattern of ups and downs that markets face around the world -- but has lost nearly 50% of its value since December 2007. This has rattled more than confidence, given that national employment pensions (AFP) are heavily invested in the market. That is, it has caused a dramatic decrease (38%) in the values of Peruvian workers' retirement holdings, particularly troubling for those newly invested or nearing retirement, and 50% aggregate value of the 261 companies listed on the exchange. Whatever the temptations, the Government of Peru has not sought to mimic the Government of Argentina by

nationalizing the pension system but rather has proposed to create a fourth more stable fund intended to protect the pensions of workers 60 years or older.

DIVERSIFYING MARKETS AND EXPORTS MITIGATING FACTOR
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¶4. (SBU) The crisis has also caused a drop in commodity prices, on which Peru's export base and foreign cash earnings remain heavily dependent. The minerals sector, for example, constitutes 63% of Peru's exports. So far mineral prices have fallen on average by nearly 50 percent from earlier this year. While still largely unfelt, a longer-term impact may come if the country's export markets, particularly China, cut down their imports from Peru. Some analysts believe that Peru's progress in diversifying its export products to include fruits and vegetables among others should help mitigate the loss of its commodity export revenue. On the other hand, demand for these new Peruvian exports, particularly textiles, have also dropped over the past months, and any potential gains in these sectors are unlikely to be sufficient to compensate for the losses in Peru's still predominant mining sector.

¶5. (SBU) Given that the origin and epicenter of the crisis has been the U.S., Peruvians are principally concerned about American purchases of Peruvian products. Most of Peru's minerals and metals sell on a long-term basis (contracts are set in advance for the amount to be purchased in a given time frame) so a lower demand for metals in the U.S. will affect prices, but not mine output. Initial data is ambivalent. While American consumers appear to be demanding fewer luxury items such as textiles and apparel, primary goods such as fruits and vegetables have maintained the same level of market demand. But it is the longer term outlook on U.S. imports from Peru, as the crisis' impact on the real economy in the U.S. begins to emerge, that causes most concern here.

¶6. (SBU) Peru's diversifying trading partnerships -- reflected in the series of trade agreements it has initiated or signed over the past year -- and incipient "decoupling" from the U.S. could soften the blow. This year, Peru signed free trade agreements with Canada and Singapore, and began or

continued negotiations with China, Mexico, the EU, the European Free Trade Association (EFTA), and Chile. Peru has completed negotiations with Thailand, and is planning negotiations with CAFTA-DR, South Korea and Japan for 2009. The GOP is also discussing Russia, Morocco, India, South Africa, and New Zealand as future trade agreement partners. The success of this strategy is reflected in trade figures of the past ten years that show Peru more than tripling its trade with Asian countries since becoming a member of the Asia Pacific Economic Cooperation. Even so, the export mix to these partners, particularly Asia and Europe, is even more heavily reliant on minerals.

COMMENT: THE POLITICS OF THE ECONOMIC CRISIS

¶7. (C) Peru has followed a politically pragmatic, trade and investment-friendly economic model that has delivered steady and, in recent years, even impressive growth. In seeking to protect and to build on these gains, the global financial/economic crisis has surged as an unexpected and potentially problematic obstacle. If the strictly "economic" impact of the crisis may be less severe than elsewhere, nonetheless it is and will be real -- and few can predict its ultimate scope and limits. A secondary but important impact may be on the still fragile political underpinnings of Peru's economic success, the tenuous political consensus regarding the economic way forward. While not yet widespread or politically acute, national and international commentary announcing the "death of liberal capitalism" has found some traction here. To a degree, the debate was reflected in the (perhaps coincidental) recent cabinet reshuffle in which a left of center regional leader with close ties to social sectors replaced a pillar of the government's business-friendly policy environment. It will also be reflected in the results of internal government discussions regarding whether further belt-tightening or rather increased government spending is the best way to navigate the turbulent waters.

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